

## Message Text

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ACTION EB-04

INFO OCT-01 SS-04 ISO-00 NSC-04 NSCE-00 TRSE-00 FRB-03

INR-01 CIEP-01 CIAE-00 DRC-01 RSC-01 /020 W

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R 081753Z AUG 74

FM AMEMBASSY BONN

TO SECSTATE WASHDC 4291

C O N F I D E N T I A L SECTION 01 OF 03 BONN 12552

LIMDIS GREENBACK

DEPARTMENT PASS TREASURY AND FEDERAL RESERVE

E.O. 11652: GDS

TAGS: EFIN, GW

SUBJECT: HERSTATT

REF: BONN 10557

1. SUMMARY. THE BUNDESBANK BOARD IS FURTHER DIGGING IN IN THE DEFENSE OF ITS ACTIONS IN THE HERSTATT CASE AND RULING OUT ANY SPECIAL TREATMENT FOR THOSE BANKS CAUGHT IN THE INTERRUPTION OF THE DM/\$ SPOT CLEARING CYCLE. A FURTHER UNPUBLICIZED ATTEMPT BY GERMAN BANKS TO RAISE FUNDS TO MORE FULLY COMPENSATE HERSTATT LOSERS HAS FAILED. THE FINANCE MINISTRY CONTINUES TO WORK TOWARD PERSUADING GERLING AND GERMAN BANKS TO CONTRIBUTE ADDITIONAL MONEY TO MAKE POSSIBLE A FAIRLY GENEROUS SETTLEMENT OF HERSTATT LOSSES THIS FALL. PROSPECTS REMAIN UNCERTAIN, HOWEVER, AND SOME HERSTATT LOSERS INSTEAD ARE PRESSING FOR THE OPENING OF BANKRUPTCY PROCEEDINGS. END SUMMARY.

2. THE FOLLOWING REPORT IS BASED ON SEPARATE CONVERSATIONS THE FINANCIAL ATTACHE HAS HAD THIS WEEK WITH BUNDESBANK VICE PRESIDENT EMMINGER AND TWO OTHER  
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MEMBERS OF THE BUNDESBANK BOARD.

3. EVEN IN RETROSPECT THE BUNDESBANK DOES NOT BELIEVE THAT GIVEN THE SITUATION AS IT DEVELOPED, THE HERSTATT CASE SHOULD HAVE BEEN HANDLED VERY DIFFERENTLY. UNDER THE CONTINUING BARRAGE OF GERMAN AND INTERNATIONAL CRITICISM, THE BUNDESBANK BOARD--WITH ONLY VERY MINOR INDIVIDUAL NUANCES--IS CLOSING RANKS BEHIND PRESIDENT KLASSEN AND IS ALSO DIGGING IN ON THE DEFENSE OF THE INTERRUPTION OF THE DM/DOLLAR SPOT CLEARING CYCLE AND THE DENIAL OF SPECIAL TREATMENT TO THOSE CAUGHT IN IT. AS THE BUNDESBANK SEES IT, ON SUNDAY, JUNE 23, WHEN KLASSEN WAS INFORMED OF THE HERSTATT PROBLEM IT LOOKED AS IF A RESCUE OPERATION HAD A GOOD CHANCE OF SUCCESS AND ONLY IN SUBSEQUENT DAYS DID THIS POSSIBILITY FADE AS THE MAGNITUDE OF THE LIKELY

. HERSTATT LOSSES BECAME EVER BIGGER AND INDETERMINABLE AND AS THE ABILITY OF GERLING TO MAKE UP THESE LOSSES WITH THE PROCEEDS OF A LONG TERM LOAN FROM THE BIG THREE COMMERCIAL BANKS FADED AWAY SINCE HIS OWN NET WORTH THROUGH WHICH THIS LOAN WAS TO BE SECURED TURNED OUT TO BE VERY DIFFICULT TO ESTABLISH. WHEN IT FINALLY BECAME ABSOLUTELY CLEAR ON WEDNESDAY, JUNE 27, THAT THE RESCUE OPERATION WOULD FAIL, HERSTATT HAD TO BE CLOSED IMMEDIATELY IN ORDER TO AVOID INSIDE WITHDRAWALS AND FURTHER INNOCENT DEPOSITS. ACCORDING TO THE BUNDEABANK, OTHER BANKS WHO DISREGARDED THE DELIVERY RISK IN SPOT TRANSACTIONS SHOULD HAVE KNOWN BETTER AND CANNOT BE GIVEN A PREFERENCE OVER OTHER LOSERS. (COMMENT: THE BUNDESBANK'S TOUCHINESS AND DEFENSIVENESS ON THESE QUESTIONS IS WELL ILLUSTRATED BY KLASSEN'S PRESS CONFERENCE OF JULY 18. WE ARE TRANSMITTING THE RELEVANT PORTIONS OF THE TRANSCRIPT BY AIRGRAM.) DESPITE THE BUNDESBANK ARGUMENTS, MANY BELIEVE THAT THE PROBLEM OF THE INTERRUPTED SPOT CLEARING CYCLE WAS SIMPLY NOT THOUGHT OF AT THE TIME. IT IS POSSIBLE, HOWEVER, THAT EVEN HAD IT BEEN CONSIDERED, A POSTPONEMENT OF THE HERSTATT CLOSURE WOULD NOT HAVE BEEN POSSIBLE. WITH THE BENEFIT OF HINDSIGHT IT SEEMS TO US THAT THE MOST APPROPRIATE COURSE FOR THE GERMAN AUTHORITIES WOULD HAVE BEEN TO CONFIDENTIAL

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HAVE CLOSED HERSTATT ON SUNDAY, JUNE 27. THIS WOULD HAVE MADE IT POSSIBLE TO BRING IN OTHERS IN THE RESCUE OPERATION, AVOID THE INSIDE ADVANTAGE OF THE BIG THREE GERMAN BANKS, AND INCREASED THE CHANCES OF RESCUE SINCE PARTICULARLY THE SAVINGS AND GIRO BANKS WOULD HAVE BEEN WILLING TO CONTRIBUTE IN VIEW OF THEIR LARGE LOSSES DUE TO THE HERSTATT CLOSING. IF A CONVINCING RESCUE COULD HAVE BEEN ARRANGED, HERSTATT

COULD HAVE BEEN REOPENED; IF NOT, THE INTERRUPTION OF  
THE FOREIGN EXCHANGE CLEARING CYCLE WOULD HAVE BEEN

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INR-01 CIEP-01 CIAE-00 DRC-01 RSC-01 /020 W

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R 081753Z AUG 74

FM AMEMBASSY BONN

TO SECSTATE WASHDC 4292

C O N F I D E N T I A L SECTION 02 OF 03 BONN 12552

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AVOIDED.)

4. FOLLOWING THE HERSTATT CLOSURE, ANOTHER ATTEMPT  
WAS MADE BY GERMAN BANKS UNDER THE LEADERSHIP OF THE  
BIG THREE TO FIND A WAY TO FULLY COMPENSATE HERSTATT  
LOSSES. A COMPLICATED PROPOSAL WAS WORKED OUT  
WHEREBY THE BUNDESBANK WOULD PREMATURELY REDEEM AT  
PAR 3 PERCENT EQUALIZATION CLAIMS OF GERMAN BANKS  
(STEMMING FROM THE 1948 CURRENCY REFORM) WHICH IN  
TURN WOULD CONTRIBUTE TO THE HERSTATT LIQUIDATOR THE  
GAIN TO THEM RESULTING FROM BEING ABLE TO REINVEST  
THE PROCEEDS AT MUCH HIGHER CURRENT RATES OF INTEREST.  
IN ADDITION, THE BANKS WOULD UNDER THE PROPOSAL HAVE  
TURNED OVER TO THE HERSTATT LIQUIDATOR THE TAX  
SAVINGS THEY REALIZED THROUGH BALANCE SHEET LOSSES  
DUE TO THE TURNOVER OF THESE FUNDS TO HIM. THE  
SCHEME FLOUNDERED HOWEVER DUE TO LEGAL DIFFICULTIES  
AND RELUCTANCE BY THE COMMERCIAL BANKS TO TAKE THE  
BALANCE SHEET LOSSES INVOLVED (PRESUMABLY BECAUSE THE  
EQUALIZATION CLAIMS ARE CARRIED ON THEIR BALANCE  
SHEETS AT PAR). WHETHER THE BUNDESBANK WOULD HAVE  
BEEN WILLING TO PARTICIPATE IF LEGAL DIFFICULTIES HAD

NOT ARISEN IS UNCLEAR. IN ANY CASE THE PROPOSAL APPARENTLY IS DEAD NOW. THE ATTEMPT HAS NOT YET LEAKED TO THE GERMAN PRESS. PLEASE HOLD IT CLOSELY.

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5. KLASSEN'S AND EARLIER GOCHT PRESS CONFERENCE STATEMENTS MAKE IT VERY CLEAR THAT THE BUNDESBANK DOES NOT FEEL THAT IT IS IN ANY POSITION TO UNDERTAKE ANY SPECIAL ACTION IN FAVOR OF THOSE BANKS HAVING LOSSES DUE TO THE INTERRUPTION OF THE SPOT CLEARING CYCLE. EARLIER PRESS REPORTS OF SOME ASSURANCES BY KLASSEN TO SAMUEL HILL IN THIS REGARD WERE BASED ON A MISUNDERSTANDING. ALL THAT KLASSEN SAYS HE ASSURED SAMUEL HILL IS THAT THE BUNDESBANK WOULD APPROACH THE HERSTATT LIQUIDATOR WITH THE REQUEST TO QUICKLY DETERMINE WHETHER A SPECIAL TREATMENT FOR THE INTERRUPTED SPOT TRANSACTION WAS POSSIBLE. THIS WAS DONE AND THE LIQUIDATOR HAS DETERMINED THAT IN HIS VIEW THIS IS LEGALLY NOT POSSIBLE. AS FAR AS THE BUNDESBANK IS CONCERNED THIS SETTLES THIS QUESTION.

6. IT IS EXPECTED THAT HERSTATT LIQUIDATOR WILL BE ABLE TO GIVE A PRELIMINARY INDICATION IN THE FALL OF THE PERCENTAGE AT WHICH CLAIMS CAN BE SETTLED. STATE SECRETARY POEHL IS PUTTING PRESSURE ON GERLING AND THE GERMAN BANKS TO GUARANTEE AT THAT TIME A CERTAIN PERCENTAGE SETTLEMENT SO THAT ALL CLAIMS CAN BE PAID OFF AT ONCE WITH THE GUARANTORS MEETING ANY DEFICIT THAT MIGHT ARISE WHEN THE LIQUIDATION IS FINALLY CONCLUDED. EMMINGER TOLD THE FINANCIAL ATTACHE THAT HE DOUBTS WHETHER THIS TIME SCHEDULE CAN BE MAINTAINED. HE BELIEVES THAT THE SPREAD IN THE LIKELY MINIMUM AND MAXIMUM SETTLEMENT PERCENTAGE FORESEEABLE THIS FALL WILL BE SO LARGE THAT THE POTENTIAL GUARANTORS WILL NOT BE WILLING TO GUARANTEE SETTLEMENT AT THE UPPER RANGE OF THAT SPREAD AS POEHL HOPES. IN ADDITION, AGREEMENT OF TWO-THIRDS OF THE CREDITORS (AND A SETTLEMENT QUOTA ABOVE 35 PERCENT) MUST BE OBTAINED IN ORDER TO LIQUIDATE AND AVOID FORMAL BANKRUPTCY PROCEEDINGS. SOME LARGE CREDITORS, SUCH AS THE CITY OF COLOGNE, HOWEVER, ARE PUSHING FOR BANKRUPTCY PROCEEDINGS. THEY ARE DOING THIS BECAUSE IN SUCH PROCEEDINGS GERMAN LAW PROVIDES SOME POSSIBILITY (BUT FAR FROM A CERTAINTY) OF ESTABLISHING A PERSONAL LIABILITY OF GERLING AS THE CHAIRMAN OF THE BOARD OF HERSTATT IF A DERELICTION OF DUTIES ON HIS PART CAN BE PROVEN. THESE CREDITORS

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HOPE IN THIS WAY TO GAIN ACCESS TO GERLING'S PRIVATE FORTUNE. POEHL, ON THE OTHER HAND, HOPES THROUGH PUBLIC PRESSURE TO GAIN SOME ADDITIONAL VOLUNTARY CONTRIBUTION BY GERLING TO FACILITATE A QUICK SETTLEMENT IN THE FALL. ANOTHER OPEN PROBLEM IS, OF COURSE, THE DISPOSITION OF THE HERSTATT FUNDS IN NEW YORK AND WHETHER THEY WILL ENTER THE GERMAN LIQUIDATION OR WILL BE LIQUIDATED INDEPENDENTLY AND PARALLEL TO THE GERMAN PROCEEDINGS.

7. IN GERMANY A NUMBER OF LEGAL PROBLEMS ALSO REMAIN TO BE SOLVED AND PARTICULARLY TO WHAT EXTENT BANKS ARE ALLOWED TO BALANCE THEIR HERSTATT CLAIMS AND OBLIGATIONS AND TO WHAT EXTENT THEY INSTEAD MUST SUBMIT THEIR CLAIMS TO THE LIQUIDATOR FOR PERCENTAGE

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SETTLEMENT WHILE PAYING THEIR OBLIGATIONS IN FULL TO HIM. A PARTICULAR PROBLEM IS POSED BY UNCOMPLETED FORWARD FOREIGN EXCHANGE TRANSACTIONS. THE HERSTATT LIQUIDATOR HAS ASKED BANKS TO COVER THESE TRANSACTIONS IMMEDIATELY. IF THIS RESULTS IN A LOSS COMPARED TO THE FORWARD CONTRACT WITH HERSTATT, THERE IS LITTLE

DOUBT THAT THE LOSS WILL BE SUBMITTED AS A CLAIM AGAINST THE LIQUIDATION MASS. THE POSITION IS LESS CERTAIN, HOWEVER, IF ANOTHER BANK REALIZES A GAIN (OR REDUCES ITS LOSS) BY THIS PROCEDURE AS COMPARED WITH ITS ORIGINAL FORWARD CONTRACT WITH HERSTATT. THE HERSTATT LIQUIDATOR MAINTAINS THAT IN THIS CASE THE GAIN MUST BE TRANSMITTED TO HIM. SOME BANKS (SUCH AS THE DEUTSCHE BANK) AGREE. OTHERS (SUCH AS COMMERZ BANK) ARGUE THAT SINCE HERSTATT CEASED TO EXIST, THE FORWARD CONTRACT ALSO HAS CEASED TO EXIST AND THE LOSS THUS HAS BEEN AVOIDED AND NO TRANSFER OF FUNDS TO THE LIQUIDATOR IS REQUIRED OR AT THE VERY LEAST THE AVOIDED LOSS CAN BE BALANCED AGAINST OTHER CLAIMS OF THE BANK CONCERNED AGAINST HERSTATT. FOR ALL OF THESE REASONS IT IS NOT POSSIBLE AT THIS TIME TO PREDICT EITHER THE SETTLEMENT QUOTA OR THE TIMING OF THE SETTLEMENT.

8. ALMOST EVERYONE AT THE BUNDESBANK AND THE FRANKFURT COMMERCIAL BANKS TO WHOM THE FINANCIAL  
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ATTACHE TALKED AGREED THAT IT IS NO LONGER A QUESTION WHETHER THE BULK OF THE SMALL GERMAN PRIVATE BANKS CAN SURVIVE, BUT ONLY A QUESTION HOW SOON AND HOW SMOOTHLY THEY WILL BE TAKEN OVER BY OR ASSOCIATED WITH BIGGER BANKS. WHILE TEMPORARY LIQUIDITY PROBLEMS CAN AND ARE BEING COPEDED WITH, THE LOSS OF CONFIDENCE, BUSINESS AND DEPOSITS BY SMALL PRIVATE BANKS IS LIKELY TO BE PERMANENT. IN ADDITION, SOME ARE LIKELY TO GET INTO FURTHER DIFFICULTIES, IF NOT THROUGH FOREIGN EXCHANGE FORWARD CONTRACTS, THEN THROUGH BANKRUPTCIES OF THE CONSTRUCTION FIRMS TO WHOM THEY HAVE LOANED LARGE AMOUNTS.

9. THE BUNDESBANK CONTINUES TO STRESS THAT THE HERSTATT SHOCK HAS HAD A HEALTHY EFFECT ON GERMAN BANKING AND HAS LED TO A RE-ESTABLISHMENT OF SOUNDER PRACTICES NOT ONLY IN THE FOREIGN EXCHANGE BUT ALSO IN OTHER FIELDS. MANY PRIVATE BANKERS AGREED ONLY PARTIALLY AND CONTINUE TO BELIEVE THAT THE HERSTATT CLOSURE COULD AND SHOULD HAVE BEEN AVOIDED AND THAT AT THE MINIMUM THE TIMING OF THE CLOSURE WAS A MISTAKE. WHILE ALMOST EVERYONE WELCOMES THE CONTRACTION OF THE FOREIGN EXCHANGE MARKETS, MANY PRIVATE BANKERS FEEL THAT IT HAS GONE TOO FAR AND THAT THE LIMITATION ON BANKS OPEN FOREIGN EXCHANGE POSITION CURRENTLY PROPOSED BY THE GERMAN BANKING SUPERVISORY AUTHORITY (FOR DETAILS SEE BONN'S WEEKLY AIRGRAMS ON FINANCIAL DEVELOPMENTS) IS TOO SEVERE

FOR THE FORWARD MARKETS TO OPERATE EFFICIENTLY.  
WHILE THEY DO NOT BELIEVE IT LIKELY THAT THE PROPOSED  
20 PERCENT RATIO BETWEEN A BANK'S OPEN FORWARD POSITION  
AND ITS EQUITY CAPITAL WILL BE CHANGED, THEY DO  
BELIEVE THAT SOME MODIFICATION CAN AND MUST BE  
OBTAINED IN WHAT COUNTS AS AN OPEN FORWARD POSITION  
AND IN THE DEGREE TO WHICH THE EXACT TIMING OF  
FORWARD LIABILITIES AND CLAIMS MUST BE MATCH TO  
AVOID AN OPEN POSITION FOR PURPOSES OF THE 20 PERCENT  
RATIO.  
HILLENBRAND

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## Message Attributes

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